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DEPARTMENT FOR EUR/NCE AND EB/OMA, AND INR/EC
TREASURY FOR JEFF BAKER AND LARRY NORTON

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SUBJECT: THE GOH CONTINUES A DEFICIT REDUCTION DIET

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¶B. BUDAPEST 639
¶C. BUDAPEST 593

Classified By: P/E COUNSELOR ERIC V. GAUDIOSI; REASONS 1.4 (B) AND (D)

LITTLE APPETITE FOR ECONOMIC REFORM...

¶1. (C) Financial analysts generally agree that the current government has neither the ability nor the appetite to enact economic reforms that will address underlying causes of slow economic growth in Hungary. As Oriens Consulting Group Partner and former OPT Bank Research Director Tamas Vojnits points out, "the political leadership knows what the economy needs," but is unwilling to undertake reforms that could alienate real or perceived constituencies like pensioners or recipients of state assistance.

¶2. (C) According to Kopint-Tarki CEO Eva Palocz and others, high taxes on labor and the highest redistribution rate in Central Europe continue to stifle Hungary's economic growth. They point out that the current tax and social benefit system does not incentivize employment, and contributes to Hungary having one of the lowest labor participation rates in the EU. Former Minister of Finance Lajos Bokros notes candidly that Hungary is saddled with a system that "turns out low quality at a high cost." Oriens analysts point out that a continued failure by the GOH to address these underlying issues is causing Hungarian living standards to decline relative to other Visegrad countries, a trend which one observer notes "makes us mad ... but not motivated."

¶3. (C) Instead of tackling these structural problems, the government plans to continue to focus on deficit reduction through its Convergence Program. Finance Minister Veres recently reiterated the government's primary macroeconomic goals as promoting stability and reducing the budget deficit. Hungary's deficit reduction success to date, however (a reduction from nearly 9 percent in 2006 to a likely rate of 3.8 percent in 2008), has largely been the result of increased tax revenue, and not through cuts in government expenditures. Some worry that it also risks foreign policy fallout. As one visiting EC staffer points out, the constant refrain of "Brussels made me do it" is driving down popular regard for Hungary's membership in the Union.

...EXCEPT FOR BREAD AND CIRCUSES

¶4. (U) Although many senior policy-makers are currently on their August break (ref a), details of the government's 2009 budget proposal and proposed tax changes are beginning to emerge. Media sources report that the government is considering lowering the current 20 percent VAT rate on energy and basic food products to 18 percent, but increasing the VAT to as much as 25 percent on other items. Finance Ministry officials would not confirm the details, but confirmed that modest VAT rate changes would likely be

proposed. Kopint-Tarki's Palocz notes that a 2 percent VAT reduction will not likely provide significant relief to Hungarians currently faced with an inflation rate of 6.7 percent, as only about half of the value of VAT rate reductions historically trickle down to consumers (unlike VAT increases, which are generally fully passed on to consumers). Such a step might, however, help the government protect its political flank from attacks by the opposition, which has proposed even deeper cuts in the VAT on food and fuel.

¶5. (U) Finance Minister Veres has announced that next year the temporary four percent "solidarity tax" on business would be abolished, a major priority of U.S. and other international firms. (Note: this follows private references to the possibility of a phased removal of the tax. End note.) Finance Ministry sources confirm that next year's budget will include tax cuts of at least 100 billion forints (approximately USD 625 million), but are thus far offering few specifics, noting that the 2009 budget proposal is still under discussion within the government.

¶6. (C) Although Ministry of Finance Economic Policy Deputy Director General Laszlo Toth describes the Convergence Program as a "fiscal consolidation period", next year's budget will not likely include significant cuts in government expenditures. Toth predicted the budget would include only a slight reduction in spending (relative to GDP growth), and not a reduction in nominal terms. He further noted that the 2009 budget may include a slight real wage increase in public sector salaries, another bread and circuses step aimed at Hungary's enormous bureaucracy. As MSzP staffer Gyula Cserei notes, "there are some things a Socialist government can't do

... and some things it must do."

INCREASING THE SIZE OF THE PLATE...BUT NOT STEPPING UP TO IT

¶7. (U) The government has recently enjoyed some success in increasing tax revenues by "whitening" the economy, through regulatory changes aimed at ensuring proper reporting of wages and through more vigorous investigation and enforcement of tax regulations. Toth credits the government's whitening efforts as one of the reasons budget deficit estimates for 2008 were recently revised downward to 3.8 percent (from 4 percent). Most analysts agree, however, that the gray economy remains a major source of lost government revenue.

¶8. (C) Comment: Despite receiving some favorable reactions to its deficit reduction efforts, the government will be increasingly concerned about average voters rather than economic analysts as the 2009 European Parliamentary elections approach. Few expect the current government to undertake unpopular structural reforms to boost long-term economic growth. Bokros believes that "an isolated government and an isolationist public" will lead to "more muddling through," and analysts here often comment that the government is really on a fast more than a considered diet. Based on pre-election spending sprees in 2002 and 2006, many also continue to question whether the GOH will be able to maintain fiscal discipline in the run-up to the 2010 elections, particularly if the EU eases pressure on Hungary by lifting its "excessive deficit procedures" should Hungary meets its 3.2 percent deficit target in 2009. End comment.

Levine